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INSURANCE OBSERVER

A Darkness on the Edge of Town

This Wheel's on Fire

If Hank Greenberg, chairman of American International Group and emperor of the insurance industry, forgot to put on clothes, it's a safe bet that no securities analyst would mention it. Saying something that might be interpreted as critical of Greenberg could be lethal to an analyst's career. Even if such an analyst weren't fired, he'd be the *only* one questioning the Great Man, and nobody on Wall Street wants to be the *only* one doing anything.

Securities analysts often travel in herds, opining on stocks with an arsenal of euphemisms including "aggressive buy," "strong buy," "buy," "outperform," "accumulate," "market perform," "strong hold," and "hold."

Although there's something known as a "sell" opinion, to the best of our knowledge it's invoked only during nuclear war or a prolonged bear market. Analysts simply aren't in the business of shouting "sell" in a crowded market. (If every security were a "hold" or a "sell," brokerage firms wouldn't transact much business.)

"...and then Hank Greenberg decided to buy SunAmerica for $16 billion in stock."

American International Group (AIG, $79) is *the* blue chip insurance stock. It's huge (a market cap of $85 billion), it's liquid (average daily volume is 1,982,636 shares), and it has been a dazzling success. Under Greenberg's long tenure, AIG has achieved remarkable growth—without a surfeit of risk. Since going public in 1969, its stock has compounded at an 18.6% annual rate.

Particularly alluring to investors, however, is the consistency with which AIG has grown: with the exception of 1984, earnings have increased every year.

A recent Zacks composite tracked 21 analysts who followed AIG. Of these, six rated the stock a "strong buy" and 12 rated it a "moderate buy"; three heretics rated it a "hold." The analysts' earnings-per-share projections for AIG were consistent. The lowest for this year is $3.45; the highest is $3.57. For 1999 the lowest is $3.85; the highest, $4.10. The consensus is $3.98.

Although Warren Buffett has said that he prefers a lumpy 20% return to a smooth 15%, many investors apparently prefer

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Nightmare at the Mutuals

If it's Tuesday, this must be Des Moines.

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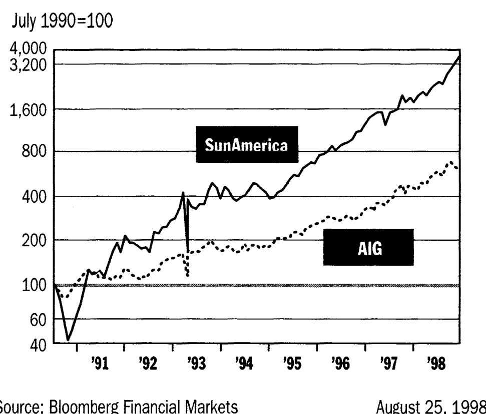
just the opposite: they prize consistency and predictability (or what they perceive as such), and are willing to pay more for it. Because AIG is a fine company with a powerful global presence, and because its earnings have compounded at a 14% rate over the past decade, investors believe it's a *perpetual* money-compounding machine. They have bought the theory that AIG is a "growth" company (rather than a cyclical insurance or financial company) and as such deserves a significantly higher multiple than would otherwise be accorded. Although AIG's stock has retreated from a recent high of $102\frac{5}{16}$, it's still trading at 24 times earnings and more than three times book value (see the graph at the bottom of page 3).

Investors justify these multiples on the grounds that AIG is "safe": its earnings won't disappoint stockholders. In buying AIG, money managers are, in effect, paraphrasing an old expression once popular among purchasers of data-processing equipment: "Nobody ever lost his job buying AIG."

Despite AIG's achievements, two questions are worth asking: 1) What will happen to the company when Greenberg, who is 72, is no longer there? 2) How has AIG generated such consistent earnings growth, and what is the likelihood that this *consistent* growth will continue?

The SunAmerica Also Rises

Since July 1990, SunAmerica's stock has appreciated 3,548%, versus 514% for AIG's stock.



Source: Bloomberg Financial Markets — August 25, 1998

Obviously, no one knows the answer to the first question. It turns out that no one quite knows the answer to the second question, either. Some who follow AIG have told us that they can't really analyze it. Others have said that they don't even spend much time *trying* to do so—that, to a larger extent than they would for other companies, they take AIG's numbers on faith.

AIG is difficult to get a handle on. State Farm, for example, is bigger, but easily lends itself to analysis: it operates in a few lines, sells standard products, barely uses reinsurance, and invests (successfully) in high-quality bonds and stocks.

AIG, by contrast, is a sprawling omnipresence that does business in 130 countries and has 500 subsidiaries. Its Domestic General Business, which accounts for 32% of pretax income, specializes in almost every form of complex casualty coverage imaginable. AIG's life-insurance operations, which operate primarily in Japan, Taiwan, and other Asian countries, account for 34% of its pretax income. (AIG doesn't break down premium by country or product.)

AIG's Financial Services Group, which benefits from AIG's triple-A rating, leases planes, engages in a significant derivatives business, makes markets in foreign exchange and bonds and metals, manages funds, and provides private-banking services. It has grown rapidly and accounted for 15% of AIG's pretax income—$701 million last year. (That's twice what Charles Schwab & Company made in 1997.)

In April, Weston Hicks and Christine Lai of Sanford C. Bernstein & Company put out an 82-page report, *American International Group, Inc.: The Emperor of Financial Services*—the most comprehensive analysis we've read on AIG. [To purchase a copy, call Sandy Prasch at (212) 756-4106.] Hicks and Lai believe that AIG is a "preeminent global financial-services company" (we agree) that "stands at the threshold of increased opportunity" (we're not so sure). Their observation that AIG sells "at a substantial discount to other global franchise companies such as General Electric (30x 1998 consensus) and Coca-Cola (45x 1998 consensus)" is certainly true. We wouldn't buy GE or Coke at those multiples, however, nor would we value AIG at 30 times earnings, as Hicks and Lai suggest might be appropriate. We're hesitant to put such multiples on *anything*, much less on insurance-and-financial-services companies which, historically, have had lower barriers to entry. (Hicks and Lai acknowledge that AIG is a "perennially expensive stock," and have initiated their research coverage with an "outperform" recommendation.)

Given the cyclicality and competitiveness in AIG's businesses, it strikes us that the company, as now configured, might have difficulty achieving the growth that's expected of it. Can any financial company—especially one this large—compound its earnings per share at a 14% annual rate indefinitely? Can such a company always sidestep the risks inherent in commodity-like financial businesses? Perhaps, but at 23 times earnings, AIG's stock provides little margin for error—a margin that got even slimmer, we think, on August 19, with the announcement that AIG would be acquiring SunAmerica for stock, a transaction that values SunAmerica at 28 times earnings and five times book value.

Greenberg is not known as a man to overpay for things. (We ran into him once at Brooks Brothers during an after-hours sale.) Only four months ago, at AIG's annual meeting, he said, "As many of you know from previous meetings, we would like to increase our U.S. life insurance operations, and we have looked at companies for years, but we have a disciplined approach to acquisitions." In a nod to Wall Street's preoccupation with *reported* earnings, he added, "We do not want to pay

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four times book value for something and have huge amounts of goodwill that we have to write off forever." Goodwill is an accounting concept; it affects *reported* earnings (the goodwill must be written off over time), but has no impact on *economic* earnings.

The SunAmerica deal, a stock swap, will not involve "goodwill." But it is an unequivocal statement of Greenberg's opinion of the relative valuation of the two companies: pound for pound, SunAmerica is worth more than AIG.

SunAmerica, run by the extremely clever Eli Broad (who once bought a Roy Lichtenstein painting at Sotheby's for $2.5-million and charged it on his American Express card, thereby getting many free miles), has been a great bull-market company. It sells variable annuities, which bullish people buy—rather, *are sold*—during good times. Although the history of the variable-annuity business is too short for anyone to know how it will fare during the busts that usually follow booms, it's logical to surmise that during a "bust" (a.k.a. "recession") people will be more concerned about *keeping* their jobs than about "investing" for their retirements.

With the SunAmerica acquisition, approximately 57% of AIG's earnings will be derived from life insurance and financial services (based on current earnings). SunAmerica is "growing at over 30% a year, and has been doing that for 31 straight quarters," noted Greenberg, in a *Wall Street Journal* interview. We note that 31 quarters ago was the first quarter of 1991—the end of the only recession in the United States during last 16 years.

Few businesses grow at 30% a year forever. With rapid growth comes risk. Although AIG can afford the risk, one wonders why, if it *could* achieve 14% annual internal growth (what everyone was already expecting), it would pay a premium price to buy into the variable-annuity business. If SunAmerica's growth were to come to a halt—stopped in its tracks by a recession, a change in the tax code, or the absence of a bull market, for example—then AIG's run of earnings increases could be broken. Then, perhaps, investors would no longer feel like paying 24 times earnings for the company.

When Shelby Cullom Davis, the great insurance investor and lifelong bull, died in 1994, his largest position was AIG. During the previous 47 years, Davis—a patrician, card-carrying member of the Establishment who took the subway each morning to his office at 70 Pine Street (AIG's headquarters)—had turned $100,000 into close to $900 million. A nimble investor and trader who owned stock in hundreds of companies, he'd made his money buying equities that were out of favor, a method he called The Davis Double Play: "Find outstanding growth stocks whose value is not generally recognized," he said. "As the quality growth of these stocks becomes apparent, they sell at a higher multiple of higher earnings and thus score spectacular gains...It is no great trick to identify those companies whose earnings are growing faster than others. The trick, it seems to us, is to identify growth companies before the market recognizes them as such."

Neither AIG nor SunAmerica has gone unrecognized, and The Davis Double Play can also work in reverse: if a company generally recognized as a growth company ceases to grow as expected, it would sell at a lower multiple of lower earnings, thus scoring spectacular losses (for those who bought at high prices).

"Avoid the Favorite Fifty, or its future equivalent," advised Davis. "Beware of unanimity of opinion, whether of trend or selection."

As longtime readers of this publication know, we were bullish on ten insurance stocks in late 1994, with AIG leading the list. In the last couple of years, however, our fondness for insurance stocks (and most other stocks) has disappeared: rampant speculation led to valuations that made no sense to us. Benjamin Graham's concept of "margin of safety" had supposedly become irrelevant because there *was no risk* in stocks.

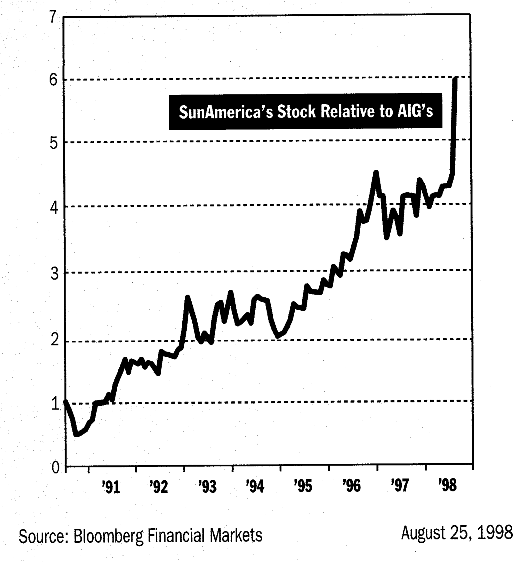
No one knows whether the market's recent decline has shattered this complacency. It has, however, made us buyers of two insurance stocks: W.R. Berkley (10 times earnings, a shade over book value, and run by one of the smartest guys in the business), and EMC Insurance Group (a conservative mutual affiliate that sells for 85% of book value and yields 4.8%).

For the record, we are not buying AIG.

Buying at the Top?

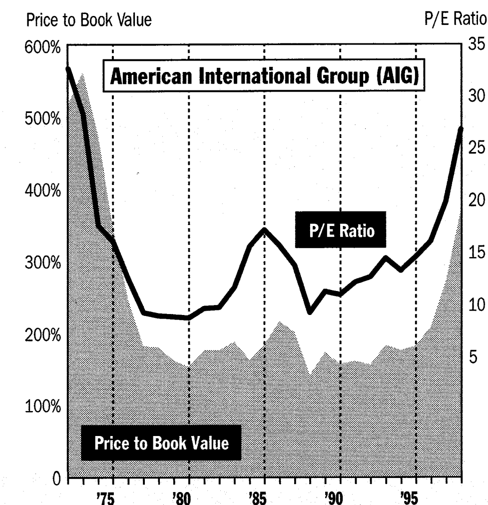
SunAmerica/AIG Relative Stock Performance

AIG is buying SunAmerica at an exchange ratio of .855 shares of AIG for each share of SunAmerica. SunAmerica is trading at the highest relative valuation to AIG in recent history.



AIG: Seems Like Old Times

In 1972, AIG's shares traded at 518% of book value and 32.6 times earnings. Between 1972 and 1974, AIG's stock fell 66%, as these inflated multiples shrank, even though AIG's earnings grew. In recent years, AIG's price/book-value ratio and P/E ratio have approached levels not seen since the early 1970's.



Primary Source: Value Line August 25, 1998

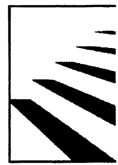
Conseco and the Joys of Synergy

Perpetual Motion on the Street of Dreams

Alexander Woollcott once remarked, "All the things I like to do are either illegal, immoral, or fattening." For some reason we were reminded of that quip while pondering Conseco, the quintessential asset-shuffling life insurance company whose creative mastery of leverage and accounting have, in the past decade, propelled its stock on a trajectory reminiscent of Neil Armstrong's 1969 summer voyage.

In our May issue we suggested that Conseco's acquisition of Green Tree Financial might be an example of "reverse synergy." (That Conseco's stock has fallen from 50 to 29 neither proves nor disproves our point.)

At first glance, Green Tree's business—making subprime loans, particularly on "manufactured homes"—appears to have little in common with Conseco's business of hawking supplemental health insurance, annuities, and universal life. At second glance, the two companies still appear to have little in common.



In Green Tree, however, Conseco sees expanded distribution capabilities and "extensive cross-marketing opportunities under the umbrella" of Conseco's "emerging national brand." If these "opportunities" do in fact lead to increased earnings, it will be an example of *synergy*: the interaction of discrete entities that produces a total greater than the sum of the parts.

Synergy is said to be a 2 + 2 = 5 concept, a financial fountain of youth—the secret sought by financial alchemists. Synergy is wonderful: it can be stretched to encompass almost anything. In the name of synergy a Japanese consumer-electronics giant might purchase a Hollywood movie studio, an international airline might build hotels in faraway places, or an American insurer might open a branch office in Jakarta.

This isn't the same sort of synergy that was exemplified 90 years ago by the Chicago Cubs' double-play combo, Tinker to Evers to Chance, three Hall-of-Famers whose lifetime offensive output included 71 home runs and a combined batting average of .274. That sort of synergy is known as "teamwork."

In the late 1960's, the concept of synergy was exemplified by National Student Marketing, whose mission was to capture the youth market. (Students don't have a lot of money; nevertheless, National Student Marketing's accountants were so good that they were able to transform losses into profits and a create white-hot *concept stock* that rose 2,380% in 18 months...before the company collapsed into bankruptcy a year later.)

Another high concept popularized during the "Go-Go Years" was the conglomerate. This offered a somewhat different take on synergy: by owning a diversified *portfolio* of businesses that had nothing to do with one another—and whose results were thus not correlated to one another or to economic cycles—a conglomerate could achieve economies of scale and generate a predictable, ever-increasing stream of earnings. (Supposedly, this stream could flow faster with the addition of leverage). Steadily rising earnings were essential because investors, in anticipation of such, would bid up the conglomerate's stock to an inflated multiple of earnings, thereby facilitating the conglomerate's use of its overvalued stock to acquire other companies, thus making earnings grow faster and the stock soar even higher. This process would be endlessly repeated, and earnings would compound at remarkable rates for eternity.

The concept of a *financial-services* conglomerate (insurance, annuities, stocks, bonds, mutual funds, deposits, loans, credit cards, and trading) is equally appealing—despite evidence that such an entity does not inevitably lead to ever-increasing profits and is prone to cyclical malfunction.

History is littered with examples of financial disasters, from USF&G's foray into mortgage guarantees in the 1920's to First Executive's overconcentration in junk bonds during the 1980's. As for the financial-services conglomerate, the best one can say is that the idea is not new. The Bank of United States "was the prototype of the modern financial-services company," writes James Grant in his definitive *Money of the Mind*. "Under its corporate ownership were three safe-deposit companies, numerous real-estate subsidiaries, an insurance company, a securities subsidiary, and a bank with fifty-seven branches... serving 440,000 depositors."

Although the Bank of United States made great contributions to the Manhattan skyline by financing two Central Park West landmarks, the San Remo and the Beresford, it ultimately lacked one indispensable feature: solvency. That same deficiency would, in due time, plague other great financial institutions such as Barings, Drexel Burnham Lambert, Integrated Resources, and Donald Trump.

While it would seem that insurance and financial services would go together like love and marriage, such is not always the case. Some examples: CNA Financial, which, in 1968 bought Tsai Management and Research, the overseer of the disastrous Manhattan Fund; Sears, which owned Allstate and bought Dean Witter in 1981, then later unloaded both; Prudential, which, by mistake, bought Bache Halsey Stuart Shields (now Prudential Securities) in 1981; and American Express, which owned Fireman's Fund and, in a lapse of judgment, bought Shearson Lehman Brothers in 1981, only to discard the pair when it became apparent that they lacked what American Express was looking for: earnings.

These companies were recent forefathers of the financial-services convergence movement, and all contributed to the study of synergy by proving that if two plus two can equal five on a good day, it can equal three on a bad day.

Which brings us back to Conseco, the burgeoning financial-services agglomeration that predicts it can perform feats of accretion, synergy, and economies of scale right before our very eyes.

Let's start with some numbers. On June 30, 1998, Conseco completed its purchase of Green Tree (which "earned" $300 million last year), in a pooling-of-interests stock transaction valued at approximately $6 billion, a not-inconsiderable 20 times earnings.

Despite Conseco's spectacular growth and $740 million of 1998 projected earnings, its shares were selling at only 15 times earnings. (Perhaps the market, in its collective wisdom—or lack thereof—was

expressing skepticism about Conseco's accounting practices.)

Although Conseco's second-quarter "Investor Guide" informs us that the company's stock has appreciated 10,800% during its 12 years of public ownership, its price/earnings ratio of 15 raises questions. How can it be *accretive* to Conseco's earnings per share for it to use its stock to pay 20 times earnings for Green Tree? Is the combination of Conseco and Green Tree that rare example of two plus two equaling five?

Some basic arithmetic: If Company C, which earns $1 per share and sells at 15 times earnings, uses its stock to pay 20 times earnings for Company G—which is the same size as Company C and also earns $1 per share—then the *combined* companies will earn 86¢ per share.

Here's how it works: assuming that each company had one share outstanding, Company C will have to issue 1.33 new shares to acquire Company G. Upon completion of the merger there will be 2.33 shares outstanding (Company C's existing share plus the 1.33 shares it issued to buy Company G). The combined companies will still earn $2, which, when divided by the number of outstanding shares (2.33), equals earnings-per-share of 86¢.

In this hypothetical example, Company C's earnings are *diluted* by its acquisition of Company G. All things being equal, when a company uses its stock to acquire a company with a higher price/earnings ratio than its own, it will be *dilutive* to the acquirer's earnings per share. Conversely, it will be *accretive* to the acquirer's earnings per share if it uses its stock to buy a company with a lower price/earnings ratio than its own.

In acquiring Green Tree, Conseco issued about 124 million common shares, bringing the number of shares outstanding to about 338 million. (Green Tree's shareholders ended up with approximately 37% of the combined company.)

Given the mathematical parameters previously discussed, Conseco's acquisition of Green Tree could be *accretive* to Conseco's earnings under a number of scenarios: 1) If Green Tree's earnings grow more rapidly than Conseco's; 2) If Conseco's earnings shrink more rapidly than Green Tree's; 3) If there are cost savings or economies of scale; 4) If there is a spontaneous combustion of synergy, and Green Tree's debtors start buying health-insurance policies from Conseco, and Conseco's annuity holders start borrowing money from Green Tree; or 5) If Conseco has very clever accountants.

It's difficult to say how likely the above scenarios are, but let the record note that Conseco has very clever accountants.

Although Green Tree has *recorded* rapid earnings growth, the quality of its earnings has left something to be desired.

From a borrowers' point of view, as *Consumer Reports* has noted, manufactured-home loans have the disadvantage of costing 200 to 300 basis points more than conventional mortgages (primarily because their 12% default ratio is about four times that of a conventional mortgage). Green Tree earns a higher rate of interest on the loans it makes because, at least in theory, it is taking a greater risk.

The process used to calculate Green Tree's earnings is, at best, an imprecise art involving numerous estimates, guesses, and assumptions. When a loan is made, a reserve for bad debt and prepayment is created; these reserves, however, may prove to be too high or too low.

In a process known as "securitization," Green Tree packages its loans into pools that are sold in the secondary markets. Green Tree still retains risk, however, because it usually provides some sort of guaranty and retains part of the original loans in the form of interest-only securities and servicing rights.

Like virtually all lending institutions, Green Tree is inherently leveraged, which invariably entails risk, such as violating a loan covenant, not being able to borrow at attractive rates, or not being able to roll over debt as it matures. In addition, Green Tree's balance sheet is exposed to adverse changes in interest rates.

Green Tree uses "gain on sale" accounting, booking revenues when a loan is securitized, rather than as it is paid off. (The revenues booked are based on the present value of *expected* interest and principal payments—money that Green Tree *has not yet received.*) According to Standard & Poor's, Green Tree's "earnings and capital quality were low, as with all companies that employ gain-on-sale accounting."

In calculating the amount of revenues to be booked, Green Tree makes assumptions about default rates, interest rates, and prepayment rates. Even if these assumptions are reasonably accurate, a small miscalculation could have a disproportionately large effect, thanks to the company's inherent leverage.

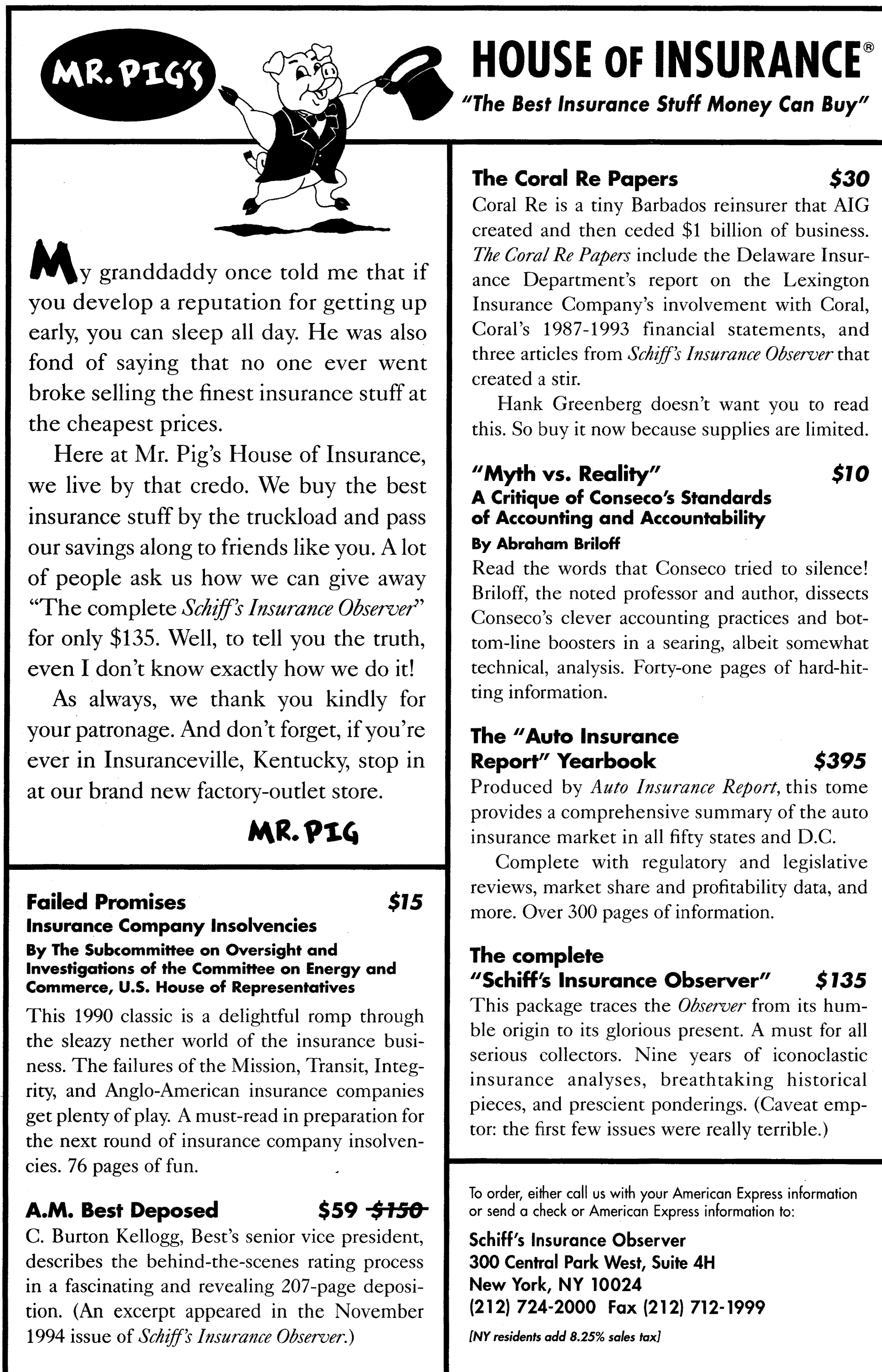
As it turned out, Green Tree's assumptions missed their mark. In November 1997 the company wrote down the value of its interest-only securities, taking a $150-million charge and restating prior results. In January 1998 Green Tree upped its pre-

Conseco's Chairman and CEO, Stephen Hilbert, several years ago

vious charge by $40 million and took an *additional* $200-million charge.

If these charges did not raise sufficient doubts about the quality, reliability, and predictability of Green Tree's earnings, then surely the July 1998 $484-million pretax writedown—which wiped out one-third of Green Tree's equity—did. This massive charge, announced by Conseco shortly after it had closed its stock acquisition of Green Tree, was the result of the implementation of something that Conseco is not known for: more conservative accounting assumptions.

"The writedown is in line with Standard & Poor's expectations, based on discussions with Conseco's management in April 1998," noted Standard & Poor's, with typical nonchalance. "[It] is a manifestation of [Conseco's] desire to begin its ownership of Green Tree on a solid accounting footing, [and] to minimize the chance of negative earnings surprises in the future."



Some speculated that Conseco's charge was a version of the "big bath" write-off in which management builds a reserve that will be used to bolster future earnings. Conseco, however, denied that to be the case.

Regardless of whether Conseco is starting its ownership of Green Tree on solid *accounting* footing, one has to wonder why the acquisition makes sense on a *valuation* footing. The $484-million write-off, for example, was greater than Green Tree's projected earnings for 1998, and greater than the company had earned in any previous year.

On the other hand, Conseco paid for Green Tree with *stock*, not cash. Conseco wasn't blindsided by the $484-million charge; for whatever reason, it made the decision that Green Tree's "earnings" were worth a higher multiple than its own earnings were.

Conseco is a marvelously complex entity that requires a whopping 120-page description in the 1998 hardcover edition of *Best's Insurance Reports*. (By comparison, *Best's* devotes 60 pages to American General, 21 pages to Prudential, 17 pages to SunAmerica, and 7 pages to Northwestern Mutual.)

Conseco's complexity is the result of a magnificent whirlwind of financial activity, which, according to Conseco's financial statements, has been quite profitable (so far). A considerable amount of Conseco's value, however, was accomplished by acquiring numerous life insurance groups with borrowed money, a technique that can no longer be employed. (The rating agencies now frown upon highly leveraged holding companies.)

Conseco, that hyperbolic earnings-growth machine, must make acquisitions if it is to keep up the heady rate of growth for which it is known and loved. Yet growth is not without risk; acquisition prices are sky high and business is intensely competitive.

As for Conseco's "extensive cross-marketing opportunities," we're not the only skeptic: "Conseco will be challenged to realize the cross-marketing potential of selling insurance to Green Tree's finance customers while also trying to manufacture loans and other finance products to be sold to Conseco's existing customer base," notes A. M. Best. "Conseco has yet to demonstrate its ability to sell multiple policies to its customers through cross

marketing its many insurance products across all lines."

As for cost savings, who knows? Conseco will maintain its headquarters in Carmel, Indiana and Green Tree will stay in St. Paul, Minnesota. Conseco's chairman, Stephen Hilbert, announced that with the combined companies' financial strength, Conseco should be able to achieve five basis points more from securitization spreads by taking advantage of timing opportunities. Shareholders had better hope that Conseco's timing is good, because it will take a lot of basis points to amortize the $204 million of investment-banking fees, accounting fees, legal fees, regulatory fees, severance payments, and other merger-related costs that were incurred in acquiring Green Tree.

In a recent press release, Conseco stated that it "remains comfortable" with analysts' consensus estimate that Conseco will earn $4.08 per share in 1999. That bullish affirmation of Wall Street's hopes—made in the wake of Conseco's tumbling stock price—was no surprise. *The Indianapolis Star* had previously reported the following: "Conseco chairman Stephen Hilbert said he is *more certain than ever* that the purchase of... Green Tree will help the company deliver high-level performance. He said to expect 20-plus percent growth in earnings per share *for the foreseeable future* [emphasis added]."

The Indianapolis Star did not mention the number of years into which Hilbert can foresee the future. ■

A Note About Your Subscription

If you've been getting *Schiff's Insurance Observer* for a while, you've probably noticed that it hasn't adhered to a regular schedule. Well, that's changing. The publisher, the editor, and the writer recently had a lengthy meeting with the bulldog who types this rag, and they all decided to get more organized. From now on an issue will come out every two months—give or take a little. At least that's the plan.

As for the content of this newsletter, it will continue to be the unpredictable, insightful, delightful, iconoclastic mix that it's always been—only better.

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The Stuff That Dreams Are Made Of

Wealth Without Risk?

Remember Joseph P. DeAlessandro? He was once a big deal in the insurance business. While at AIG in the 1960's he helped invent Directors & Officers liability coverage, and later served as president of National Union. In the mid-1980's he joined Sandy Weill's Commercial Credit (now Travelers) but never attained the heights he'd previously scaled.

These days DeAlessandro travels in less elite company. He left Travelers three years ago and now, at age 67, is CEO of American European Group, a holding company for Kentucky National and Rutgers Casualty, which last year wrote $67 million in premiums and had $26 million of surplus.

More recently, DeAlessandro has taken on the additional role of chairman and quasi-president of Century Industries (Nasdaq Bulletin Board: CNTI, 23/32), a pint-sized micro-conglomerate with a knack for issuing exciting press releases and bold projections, but no knack for hitting its projections.

We know a thing or two about Century. After we wrote an article about the company a couple of years ago, it sued us for $50 million, alleging libel, disparagement, and interference. The lawsuit included a bizarre "request for admissions," stating, in part, that David Schiff was an Iranian agent named Iraj Ertefai; that Schiff acted as a front for assassins in the employ of Ayatollah Khomeni; that Schiff had written a libelous article "because of a homosexual lover's quarrel" with a former partner; and that this former partner had filed "a palimony suit relating to [Schiff's] common residence with him at 10 Columbus Circle."

These preposterous statements are false. Century eventually dropped its lawsuit and its attorney, Robert J. Flynn, Jr., wrote an apology acknowledging that the discovery requests "implied facts both unfair and untrue." (His full apology was published in our April 1997 issue.) Nonetheless, several of Schiff's witty friends still kid him about being an Iranian agent.

Century has an intriguing history. In 1993 it merged into a "shell" public company and beefed up its balance sheet via a dubious touch of accounting legerdemain: it swapped 5,000 shares of its preferred stock for 100,000 shares in something called Underwriters Insurance Group. The transaction was recorded as a $1-million addition to paid-in capital. (Absent this swap, Century would have had a negative net worth of $514,211.) Century would eventually restate its Underwriters Insurance Group "investment" to $57,500.

Underwriters Insurance Group, which was apparently based in Dublin, did not have the luck of the Irish. Its primary "asset" was stock in Underwriters *Financial* Group, a penny-stock company better known as B.R.I. Coverage (for more on B.R.I., see "The Worst Insurance Brokerage in America," *Schiff's*, August 1995). B.R.I. went bust in 1995, and several of its senior officers have been named in an 82-count indictment for conspiracy, embezzlement, fraud, missing premium trust funds, phony premium-finance deals, and other conduct unbecoming an insurance broker.

Another Underwriters Insurance Group investment was a Bermuda reinsurer, Covent Insurance Company, which—what a coincidence!—had entered into a spurious excess-of-loss reinsurance transaction with a Cayman Islands reinsurer owned by B.R.I. Coverage. Covent was ordered into liquidation in 1995.

Despite Century's tiny capitalization, in 1994 it announced its intention to purchase Prestige Casualty Insurance Company for

$3 million to $4 million, and issued a press release projecting $3 million in earnings. Neither the earnings nor the deal materialized, and several months later Prestige, which had been run by convicted insurance-con-man John Goepfert, was declared insolvent.

In a 1995 press release, Century's subsidiary, U.S. Insurance Brokers, announced its appointment as the "national association insurance plan administrator agent for the members of the Charles J. Givens Organization." Century's financial statements give no indication that any revenues emerged from this affiliation.

That's not surprising. The recently deceased Charles Givens, author of *Wealth Without Risk*, was a peddler of get-rich-quick schemes. Brad Brady, a Cedar Rapids attorney who represented plaintiffs in 1993 and 1996 trials in which juries found that Givens had committed fraud, chose understatement to describe his adversary: "He was long on promise and short on delivery." (Brady, coincidentally, is one of the attorneys representing policyholders in recent class and derivative actions involving Allied Mutual). The Charles J. Givens Organization filed for Chapter 11 in 1996, its liabilities outstripping its assets.

In a 1996 SEC filing, Century projected that U.S. Insurance Brokers would generate $104 million in premiums and $3.12 million in pretax profits from insurance programs with the National Lumber and Building Material Dealers Association and the Association of Metropolitan Sewerage Agencies. OTC Financial Network, a public-relations firm that promotes "small and micro-cap stocks" and provides "corporate image creation programs," published material stating that U.S. Insurance Brokers "created a niche market uncluttered by any competitors." Based upon Century's financial statements, we can understand why U.S. Insurance Brokers might have no competitors: the firm generated no revenues during 1997 or the first six months of 1998.

Century, which has raised millions of dollars through private placement offerings, is still making grand projections. An April 1997 SEC filing projects that its subsidiary, Century Steel Products, will earn $4,775,000 between 1997 and 2001. (Century Steel made $17,085 in 1997. In 1993 it paid trade creditors "a lesser percentage on the dollar than what was owed.")

Century's April 1997 SEC filing also contains big projections for its third-party claims administrator, Scibal Associates. If all goes according to plan, it will earn exactly $1,371,223 and $1,974,080 in pretax income in 1998 and 1999, respectively. (Scibal had pretax income of $335,521 in 1997.)

Century's most stupendous projection, however, is reserved for the exciting new business that DeAlessandro will be running—a start-up insurance company that will "take advantage of the State of Florida JUA Homeowners Insurance

Take Out Program." Under DeAlessandro's direction, this new insurance company—which will be capitalized with approximately $5.3 million—is projected to have $40 million in first-year revenues and $3.8 million in earnings. Equally optimistic is Century's projection that U.S. Insurance Brokers will receive a $2-million service fee for acting as the managing general agent.

Century also has a 45% interest in Roc Shores/Century Industries, a limited partnership that owns "Century (Overseas) Insurance Co., S.A.," which, according to Century's filings, is "a Dominican Republic captive insurance company."

An analysis of Century's SEC filings shows that Century Industries has lost about $1.4 million since 1993.

Insurance companies tend to require capital. Century has retained Security Capital Trading, run by Ray Dirks, to raise $10 million in a private placement of Senior Callable Convertible Preferred shares, followed by $12 million to $15 million in a public offering of these shares.

Dirks, who achieved fame in the early 1970's for blowing the whistle on the Equity Funding insurance scandal, is a Runyonesque stock analyst and speculator whose investment ideas are more likely to appeal to Nick the Greek than Warren Buffett.

We've known Dirks since the early 1980's. He is an amiable eccentric whose Humpty-Dumpty physique is usually carelessly attired—pants slung low, tie too short, shirttails untucked, shoes scuffed. In his 1973 book, *The Great Wall Street Scandal*, he correctly described himself as "thirty-nine, stubby, and indifferent about" his appearance.

A gambler by nature, Dirks is invariably lured by the siren song of potential high fliers. "Rather than saying something is so preposterous that I don't want to bother," he wrote, "I would say this is something worth looking at precisely because it's so preposterous."

This penchant for risk has not always served him—or his investors—well.

In the late 1970's Dirks transformed John Muir & Company, a sleepy, old-line brokerage, into the wildest bucket shop in town. He assembled a ragtag group of brokers, financial neophytes (including former Yippie Jerry Rubin), and shapely women (whose "duties" were somewhat nebulous), and turned them loose.

Muir's specialty became low-priced IPO's—penny stocks—and its deals were among the screwiest ever underwritten. Of the 49 IPO's Dirks oversaw in four years at Muir, Cayman Islands Reinsurance was perhaps the worst. According to the SEC, its prospectus didn't disclose that the company's chairman had been convicted of stock fraud, or that Cayman Re invested the proceeds from its IPO *in other John Muir IPO's*, most of which sank into oblivion.

John Muir went bust in 1981, causing an $18-million loss to the Securities Investor Protection Corporation (SIPC). Despite this setback (and others), Dirks has continued raising money for innumerable small, high-risk companies with dubious prospects.

Why is it that so many promoters end up at his door?

"Because I'm usually receptive," Dirks told us in 1992. He also said that although he liked the good life, he wasn't interested in money per se. "I love the *idea* of getting rich quick."

Ray Dirks: Raising money for Century Industries

No account of Century would be complete without mentioning that its financial statements have been audited by an assortment of accounting firms whose names are unfamiliar to us. One auditor, Esguerra & Esguerra, withdrew for the 1993 fiscal year, citing "the prohibitive cost of malpractice insurance." It was replaced by Donna Miller & Associates, which audited Century's books until it was dismissed in February 1997. On March 13, Donna Miller & Associates wrote a three-page letter to the SEC, citing various "disagreements with [Century] ...as to matters of accounting principles or practices, financial statement disclosure or auditing scope or procedure."

On March 22, Century filed an 8-K/A with the SEC, that, in essence, disagreed with the "disagreements" cited by Donna Miller. One section of the 7-page filing, signed by Century president Theodore L. Schwartzbeck, contains unusual language:

> ...In terms of the legal issues at hand, former auditor [Donna Miller & Assoc.] apparently conducted its own investigation involving a legal analysis where it concluded: a) funds were advanced to a U.S. Insurance Brokers employee to make "an active market" in [Century's] shares, and, b) that an overseas entity was an affiliate of [Century] and was purchasing [Century's] shares.
>
> [Century's] general counsel investigated these matters...[and] concluded there was no possible merit to former auditor's legal conclusions, and, further, that no violations by [Century] had taken place.
>
> After concluding this investigation...a confidential report [was delivered] to the president (which was most derogatory in reference to former auditor's allegations and analysis)...

Century's new auditor, Correa Berger & Associates, was replaced by Sobel & Co. in 1998.

We don't know if Ray Dirks will succeed in raising money for Century, and we don't know whether anyone will buy a policy from Century's insurance company. We do know that we want nothing to do with Century, its insurance companies, or its securities.

The combination of Century, Ray Dirks, and Joseph DeAlessandro is like a cocktail made from cheap whiskey, grain alcohol, and a 50-year-old Chablis: drink it at your own risk. ■

Beware of Ohio National

Bad Moon Rising

Ohio National Life Insurance Company, the Cincinnati-based former mutual that, through a mutual-insurance-holding-company conversion, is attempting to inflict upon its policyholders a malady known as lack of money, is a study in contrasts. On the one hand, it has delivered good value to its policyholders and has a flush balance sheet. On the other hand, it is trying to take that value and balance sheet away from its rightful owners—the policyholders.

Ohio National's "information statement" on the conversion plan contains the usual stuff: misleading or inadequate disclosures and a screwball "fairness opinion"—in this case from Credit Suisse First Boston. It also makes provisions for stock options for Ohio National's directors and officers. Only a cynic (or one who has been hanging around mutual life insurance companies) would suggest that this lucrative feature—which is contrary to the concept of mutuality—might have influenced the directors' decision to approve the conversion.

We note that Ohio National's directors think it fair for directors and officers to receive equity while the company's *owners* (its policyholders) are denied that right. Rather than question their integrity, we merely question their competence: we reckon that they know as much about mutual insurance holding companies as we know about repairing Maytag washing machines. (If any of Ohio National's 13 outside directors cares to chat with us on the subject—of mutual insurance holding companies, not washing machines—we'd be delighted to visit Cincinnati for a public debate.)

How does one become a director of Ohio National? To the best of our knowledge, blood oaths, secret rituals, and animal sacrifices are not involved. It does help, apparently, to be on the board of Star Banc Corporation (five directors), Cincinnati Bell Telephone (two directors) and the University of Cincinnati Foundation (two directors).

It also helps if you've taken a stroll on the moon. Neil Armstrong is, sad to tell, a member of the Ohio National board of directors that unanimously voted to teach policyholders the words to the *Mutual Holding Company Blues.*

How did Armstrong—who drives a pickup, generally avoids publicity, and lives on a 200-acre farm in Lebanon, Ohio—wind up endorsing a plan so detrimental to policyholders? We called him at Ohio National to ask that very question. A company spokesman returned our call and said that Armstrong doesn't like to talk to the press and had "respectfully declined" to comment.

Armstrong's legacy will always be that of an American hero who, on July 20, 1969, took "one small step for man, one giant leap for mankind." But history will also carry a footnote regarding the unbecoming role he has played, perhaps unwittingly, at Ohio National.

It is sad to be reminded that men who have distinguished themselves in one arena are not necessarily larger than life in another. Images of Mickey Mantle hawking Brut cologne and Joe DiMaggio peddling Mr. Coffee come to mind. But these innocuous pitches are nothing compared to those of Neil Armstrong, the silent shill for the mutual-insurance-holding-company movement.

The moon belongs to everyone, but for the policyholders of Ohio National it's only a paper moon, hanging over a cardboard sea.

Good-bye, Neil Armstrong. ■

The Center for Insurance Research is an independent, nonprofit public policy and advocacy organization that has played an active role in issues involving mutual-insurance-company reform.

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Getting Away With It

Mutual Insurance Gamesmanship

The following is excerpted from the lecture, Theory and Practice at Mutual Insurers, *given by Professor Harold Bissonette, Ph.D., CPCU, CLU, at the Richard Whitney Triennial Seminar in 1997.*

Although it is well known that mutual insurance companies are owned by their policyholders and, therefore, must be run for their benefit—managers of interdependent non-stock risk-transference mechanisms need not be impeded by this historical precedent. In the post-industrial economy, where equilibrium is counterbalanced by dynamic change, the enterprising mutual executive in the pursuit of emolument must avail himself of all options.

In due course I shall explain the methodology by which the mutual-insurance-company executive may exceed his personal financial-planning objectives. With careful execution, one can perform these techniques in all known domiciliatory venues, including the Cayman Islands, Guam, Mozambique, Panama, and Pennsylvania. Bear in mind, however, that the reallocation of resources from a mutual insurer is a complex, time-consuming matter that requires board approval; asset transfers *must* be engineered so as to reinforce the principle of deniability. Diversion is best accomplished over time, eight years being the preferable minimum.

Whereas there were numerous crude attempts to siphon value from mutuals in the past—for example, reinsuring all policies except those belonging to the directors, then liquidating the mutual—these methods have been discredited due to the risks to which they expose their practitioners: civil prosecution and nonvoluntary confinement in federal accommodations.

I shall not catalogue each and every mode of mutual-insurance-company dissimulation. Such an undertaking is beyond the scope of this lecture, and furthermore, many of the early methods were outlined in Bisbee's authoritative *Asset Conveyance at Non-stock Insurers.*

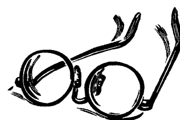
I shall also avoid discussion of "brute force" methods of executive fortification, such as the AmerUs Maneuver, the Old Guard Method, and the Principal Sidestep, all of which lack subtlety. Nor shall I discuss the Demutualization and Subsequent Remutualization Ploy, which, admittedly, was used effectively in earlier times.

Rather, the focus of today's lecture will be on what is known as the Downstream Gambit. This is the preferable method of mutual thimblerigging, for it combines the Complexity Ploy *and* the classic Fairness Opinion Block.

Allow me to explain.

Although insurance regulators are sometimes well intentioned, they are at a disadvantage to the enterprising mutual manager in that they are underfunded, understaffed, and generally unprepared for a battle of attrition. Indeed, the average commissioner's tenure is but two years. Therefore, the average commissioner, when faced with the Downstream Gambit opening, is most likely to respond with the Levin Rebuke, which calls for a counterattack that gains a token concession, such as the sacrifice of a nonstrategic objective.

For example, if a mutual's management desires stock options equal to 20% of the mutual's value, a regulatory filing should be made providing for options equivalent to 40%...plus *immediate* vesting! The commissioner can then deploy the Levin Rebuke—*halving* the options grant and *denying* immediate vesting—thereby generating the appearance of proactivity.



The mutual will respond by playing the Rebuke Accepted, at which time the commissioner will issue a press release approving the scaled-down refiled plan. The commissioner will then assert that this new plan "provides the highest possible level of consumer and public protection."

I realize that I have digressed from my topic, which was to elaborate on the Downstream Gambit, which, as its name implies, involves the formation of a stock subsidiary in which the mutual's officers and directors have significant ownership.

The downstream company will participate in a pooling arrangement with the mutual; over time the downstream insurer's percentage of the pool will be increased, thereby giving it a significant premium volume at no cost. In electing this gambit, rather than, say, a full demutualization in which all policyholders are compensated, the mutual, at its earliest opportunity, must orchestrate the Fairness Block.

The Fairness Block, by necessity, must be a lengthy document that, in essence, states that the downstream stock company (into which all value will eventually be siphoned) has been created "to preserve mutuality, to benefit policyholders, and to enhance financial strength."

I notice smiles from several of you in the audience. Let me assure you that this is no matter for amusement. The phrase I have mentioned above must become your mantra. No matter how much you may pilfer—I mean *convey*—through the Downstream Gambit, you must always respond by invoking that mantra.

For example, if asked, "Why does the mutual pay a disproportionate percentage of the pool's expenses?" you may answer, "We are fully committed to preserving mutuality." To achieve the appearance of indignation for having been asked such a question, you may add the phrase, "at all costs."

After careful practice, variations of the mantra may be employed. If you are asked, "How come ABC Mutual lost $3 million last year, while ABC Stock Company [in which the directors and officers have a large stake] made $39 million?", it is appropriate for you to use the Iowa Defense, which calls for the following riposte: "ABC Stock Company has 150,000 satisfied policyholders, and we will not apologize for our success."

The Iowa Defense, which has become the standard, *also* calls for a "fairness opinion" by a well-known investment banking firm. Preferably, the opinion will be at least five pages long and, regardless of caveats contained in the text, will close with the following line: "Based upon the foregoing, and such other factors as we deem relevant, we are of the opinion that the transaction is fair to the policyholders, as a group, from a financial point of view."

Such an opinion can be obtained from most well-known investment bankers. Although the bankers' tariff is outrageous, this is not a problem as it is borne by the mutual.

A full transcript of Professor Bissonette's speech is available by writing to the professor c/o the Federal Witness Protection Program, Washington, DC. ■

Along the Corn Belt Route

A Matter of Principal by David Schiff

No one in his right mind goes to Des Moines in the middle of January. The average temperature is 17°, and when the wind is blowing or the snow is falling, it seems colder. The streets, empty in summer, are particularly bleak in winter. Despite Iowa's negligible unemployment, the downtown area is dotted with empty storefronts and crumbling buildings.

the Principal Mutual

On January 23, 1998, I found myself in Des Moines—with good reason: a war was raging over the fate of America's mutual insurance companies and I was at ground zero, The Henry Wallace Auditorium, where a public hearing on Principal Mutual's application to convert to a mutual life insurance holding company was about to be held.

At that moment, Principal was one of the largest mutual-life-insurance companies in America. A conservative estimate of its value is $10 billion—about $15,000 per policyholder.

A handful of smaller mutual insurers had previously converted to mutual holding companies. Those conversions had taken place in the dark ages—1996 and most of 1997. (Prior to that, a mutual converting to a stock company generally paid off its policyholders in full for their ownership rights.)

One can't pinpoint when the situation began to improve, but from my perspective it was September 1997, when *Schiff's* ran a 13-page article, "The Dark Side of Demutualization," detailing how, over more than a decade, at least $500 million of value had been shuffled from Allied Mutual to its publicly traded stock-company affiliate, Allied Group, and how Allied Mutual's honchos, particularly chairman and CEO John Evans, had made a fortune in the process.

In a related article, "The Liberation of Allied Mutual," I announced my plan to wage a proxy fight to gain control of Allied Mutual's board on behalf of its policyholders. (I waived all compensation and had no hidden agenda. My motivation was simple: outrage.) I kicked off my proxy campaign with a $7,500 five-column ad in *The Des Moines Register*.

Later, many would say that my articles, combined with an almost unheard-of tactic—a proxy fight at a large mutual—raised the consciousness of the insurance world. In the ensuing months, hundreds of articles appeared in scores of publications, from *BestWeek* to *The Wall Street Journal*, and I made speeches and appeared on radio and television. Regulators, rating agencies, activists, agents, and Wall Street began paying closer attention to the behavior of America's mutuals.

At the same time as I was delving into the sleazy world of Allied Mutual, Jason Adkins, a public-interest lawyer from Cambridge, Massachusetts, was almost single-handedly doing quiet battle against a not-dissimilar perversion of mutuality: the mutual-holding-company movement, which was spreading across the midwest like a horde of locusts.

I didn't yet know Adkins, but in July 1997 I called him at the Center for Insurance Research, which he'd founded in 1991. We chatted briefly, but our paths would not cross again for several months. We met in person on October 8, 1997, at a public hearing on New York's proposed mutual-holding-company law chaired by Assemblyman Pete Grannis, who would play an key role in preventing this legislation from being enacted in New York (see "The Revolution Will Not be Televised," *Schiff's*, February 1998).

At the landmark New York hearing, Adkins made an articulate, reasoned statement. (My statement was cut short by the late hour). Afterwards, we went to a cheap joint around the corner from City Hall and had a beer and a bite to eat. Adkins is a charismatic fellow brimming with passion, commitment, and infectious good spirits, and as we chatted we discovered many shared interests.

To invoke the ending of the film *Casablanca*, this was the beginning of a beautiful friendship. Over the next ten months, the two of us—he, an activist lawyer, and I, a writer thrust into the unlikely role of activist—would attend hearings, meetings, forums, and conventions. We would run the gauntlet at state legislatures, slogging through the muck of insurance regulation. We didn't just have ringside seats at an ugly spectacle put on by some of America's greatest mutuals: we stepped into the ring ourselves and faced a giant bare-knuckled adversary who had no regard for the rules established by the Marquis of Queensbury.

As we waded deeper into the mire of mutuality-turned-upside-down, there would be countless all-nighters, dozens of trips, and innumerable phone conversations at one in the morning. In fact, Adkins is probably the only person in the world besides me who feels like having a two-hour chat about mutual insurance at that hour.

In retrospect, the Principal hearing on January 23, 1998 was a turning point in the mutual-holding-company war. From then on, a giant mutual could no longer take for granted that it could slip an abusive conversion plan through the system without encountering informed opposition. Big mutuals seeking unfair conversions were now on notice that they would have to overcome independent guerrillas whose motive—fairness—was so simple that it was *baffling* to many. These guerrillas couldn't be bought off by money, because that wasn't what they were seeking. They wouldn't compromise, either, because their cause was a matter of principle, and principles aren't something that *can* be compromised. And they couldn't be beaten by truth and facts, because both were on their side.

The mutuals, of course, had many advantages: they colluded through trade associations and ad hoc groups, they filled state capitals with their lobbyists, and they lavished money on lawyers, investment bankers, and consultants.

But power and money can't *always* force acceptance, as the mutuals quickly came to understand. Despite their financial might, they didn't fare well in the court of public opinion—once people started to understand what was really happening. Soon, the mighty Prudential and John Hancock would desert the sinking ship of the mutual-holding-company advocates, announcing full demutualizations in which their policyholders are

slated to receive 100% of the companies' value. The four large Canadian mutuals would do the same, and MONY (which had previously announced a full demutualization), would no longer be a part of the support group for the mutual-holding-company movement.

As this article is being written, MetLife, having been thwarted in its plans to become a mutual holding company, has hired Goldman Sachs and is pondering its options. The smart money is betting that a full demutualization is at the top of the list.

How I came to be involved in the war over the fate of the American mutuals is a shaggy-dog story about a lackadaisical writer who, having nothing better to do, knocked about the wide open fields of the Midwest, searching for meaning and looking for a reason to believe—and, by the way, dropped in on some insurance companies while he was there.

My involvement with Allied Mutual, and with mutual holding companies, arose by chance. In April 1996, shortly before I turned 40, I got engaged. (This would be my second marriage.) In late July, after my fiancée and I returned from a three-week trip hiking through the Swiss mountains (where we found no trace of insurance companies), we abruptly ended our relationship.

I felt relief from the end of a relationship that had soured, but that was replaced by anxiety that caused me to wonder where I went wrong and to try to make sense out of confusion.

I realized that I needed to clear my head and do something different, something meaningful. But what?

I decided to sell my insurance business (Emerson, Reid & Company, a wholesale general agency that specializes in New York State Disability), and spend time hiking, traveling, writing, and reading. I wanted to get away from people and crowds and the culture I was used to. I wanted to see a part of America that I hadn't explored—Iowa, South Dakota, and North Dakota—and drive through fields and small towns and write about what I saw and felt. (Because of the nature of this publication, I planned to write about the insurance industry, too.) I soon eliminated South Dakota and North Dakota from my agenda—not many insurance companies there. Iowa, on second thought, seemed like plenty of ground to cover.

I had been interested in Iowa ever since I'd read that it had more towns with fewer than 1,000 people than any other state. I envisioned Iowa as the embodiment of rural small-town American values—a place where folks were honest, government was clean, people didn't put you on "hold" when you called, and insurance companies believed in the golden rule.

I imagined the Iowa zeitgeist to be far removed from that of my hometown, Manhattan, where Wall Street and money—and *more* money—seemed to have permeated the fabric of daily life and were beginning to annoy the hell out of me. The Disneyfication of 57th Street and Times Square, the hum of construction, and the rise of the garish Trump International Tower across the street from my office were enough to turn New York, at that angst-ridden moment of my existence, into a place that I disdained, but, perversely, needed as much as oxygen.

Iowa, by contrast, symbolized a pastoral state filled with nice towns where people knew their neighbors and didn't bother to lock their doors. I knew that I wouldn't run into Donald Trump in the middle of

David Drury, Chairman and CEO of Principal Mutual in Des Moines

endless cornfields, nor would I encounter cigar-smoking 26-year-old money managers wearing Zegna pinstripes who speculated with their clients' funds while siphoning off 20% of the profits (but absorbing none of the losses).

Over the next two years I would discover that my initial vision of Iowa was both right and wrong. It is filled with decency, but there is a hollowness, too, and a similar decay and hypocrisy to that found in New York. All one has to do to see both is to look closely.

I arrived in Dubuque, which is on the banks of the Mississippi in eastern Iowa, on a Saturday night in mid-August 1996. The only thing I knew about Dubuque was *The New Yorker's* famous 1925 dictum that the magazine would *not* be "edited for the old lady in Dubuque."

At eleven in the evening the town was eerily silent. Nothing was open on Main Street except the Silver Dollar Cantina—a spacious saloon with a decent bar band cranking out decent bar-band music.

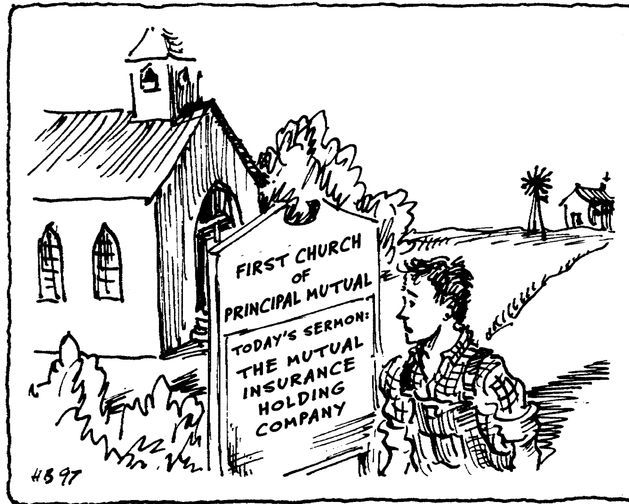
My impression of Iowa as staid was immediately jolted by five young ladies at the bar, two of whom were particularly attractive. They were having a bachelorette party, and were dressed for the occasion in tight-fitting, low-cut cowgirl clothes that caught the attention of every man in the place. Equally attention-getting were the dildos on ropes that they swung around the way a hipster in a zoot suit swings a key chain. (One girl carried her dildo in a holster.) Try as I might, I couldn't imagine any of these young ladies becoming an "old lady in Dubuque." On the other hand, I didn't picture them reading *The New Yorker*, either.

I got into my car and drove around. Just off Main Street was a small bridge that crossed the Mississippi at a narrow point. I soon discovered the Riverboat Casino, open 24 hours a day. It was past midnight, but this bright, garish, clanging hellhole was packed with people pumping the slots on all three floors.

The casino, apparently, is considered good, clean family fun. It has a special section where kids can be deposited while their parents try their luck at games of chance, the odds overwhelmingly against them. Outside the kids' room, a sign lays down the law: "Possession of any firearms within the casino without the express written permission of the Iowa Racing and Gaming Commission is prohibited."

In theory, a casino bears similarity to an insurance company—it calculates odds, takes in money in exchange for risk, and pays out less than it takes in. That, of course, is just theory. These days, it seems that the market is so soft that many insurance companies are writing business (giving odds) that no rational casino operator would offer.

Gambling is a big business in Iowa. In 1995, $7.5 billion was bet on various forms, including casinos, the lottery, bingo, dog racing, and horse racing. Statewide casino attendance was 16.9 million people, and gross casino profits were $590 million, about five percent of what Principal Mutual is worth.



I blew out of Dubuque early the next morning and was tempted to head south along the Mississippi to Davenport, where Bix Beiderbecke, one of the earliest white musicians to influence the way jazz sounds, was born 95 years ago. Beiderbecke, who is celebrated each summer in Davenport, was an alcoholic who played piano and, more famously, cornet. During his 28 years on earth he helped revolutionize America's great indigenous art form. Beiderbecke (and, more importantly, Louis Armstrong) changed the music from an emphasis on the ensemble to an emphasis on the individual and on the improvised jazz solo built upon the song. That Davenport, 800 miles north of New Orleans, was one of the birthplaces of swing, seems as unlikely as the fact that there are almost as many people working in the insurance industry in Des Moines as there are in Hartford. (Hartford is home to Aetna, Hartford, Travelers, and many other insurers. For generations it was *the* insurance town.)

I decided to forgo Davenport, however, because it is part of the Quad Cities (which include Bettendorf, Moline, and Rock Island), with a total population of 200,000. That was about 200,000 more people than I wanted to be with.

I drove north across eastern Iowa, instead, through a gently rolling terrain of winding roads, small rivers, valleys, trees, and bushes. About 50 miles to the south was Interstate 80, an endless stretch of blacktop that slices through the middle of Iowa. I abhor the Interstate System—it is not the "ribbon of highway" that Woody Guthrie sang of—and I kept I-80 at a safe distance, making the trip to Des Moines on a circuitous backroad route that was akin to going from New York to Chicago via Memphis.

As I passed by fields of corn and soybeans, rolled bales of hay, white farmhouses, small towns, and churches, I didn't realize that this trip would begin a defining series of events in my life. As I drove through the wide, empty Main Streets of the American heartland, I had no idea that I would become embroiled in what is now the biggest issue in the insurance industry: who ends up with the $300 billion in value of America's mutual insurance companies. I had no idea that the Hawkeye State, with its 119 tiny county mutuals, and its hard-working, God-fearing folks, was also a province where mutual insurance companies could be ravaged beneath the eyes of the regulators. I had no idea that the men who ran America's great mutuals were as likely to be their brothers' fleecers as their brothers' keepers. I had no idea that, 120 miles away, the first mutual holding company—AmerUs (previously American Mutual)—was coming into existence and would, five months later, go public in an abusive subscription-rights offering. I had no idea that I would soon be in Des Moines regularly, and that I would run for the board of one of Iowa's largest property/casualty mutuals. And I didn't really comprehend that the combination of a giant insurance industry and an underfunded state insurance department is as dangerous as a spark in a grain elevator.

I passed a roadside sign that told me I was entering Arlington, "where the hills and the prairie meet." Arlington is old white buildings in need of a paint job, grain elevators, and a defunct filling station. The main street is familiar: desolate, wide, and empty. Arlington has an empty bank, a new bank building, a Church of Christ built in 1896, and an American Legion hall. Some time ago an old feed mill went out of business and became the Motown Lounge, which also went out of business.

As I left Arlington I noticed that the land was flatter, that the roads were now long and straight. The terrain was broken by a few trees, some farmhouses, and poles strung with telephone wires. I imagined that people around here might go to tractor-pull contests or pickup truck races.

When I reached Oelwein, northwest of Waterloo and 50 miles south of the Minnesota border, I followed the "Corn Belt Route" for a short while. The Corn Belt Route was the Chicago Great Western Railway, which connected Chicago, Minneapolis, Kansas City, and Omaha via a hub in Oelwein.

Railroads were once the biggest business in America. Their steel rails were as important to American commerce as phone lines and cables are now. Change, however, is constant, and change—automobiles, paved roads, highways, Interstates, and airplanes—put many railroads out of business. At one time or another, almost every railroad in America defaulted on its obligations. The Chicago Great Western went bust in 1908 and again in 1935. It was taken over by the North Western in 1968, which in turn became the Chicago & Northwestern Railway, then CNW Corp., before being taken over by Union Pacific. Today, all that's left of the Chicago Great Western is a patchwork of rails-to-trails hiking and biking paths.

I continued my trip on empty dirt and gravel roads that cut through farmland. Occasionally, I'd pass over a small stream on a one-lane bridge, and every mile or so I passed a lonely farmhouse, just sitting there in the middle of nowhere.

I was somewhere near Waverly, which is north of Janesville and south of Horton, and it was overcast and raining lightly when I heard Don McLean singing "American Pie" on the car radio for the second time that day. In February 1959,

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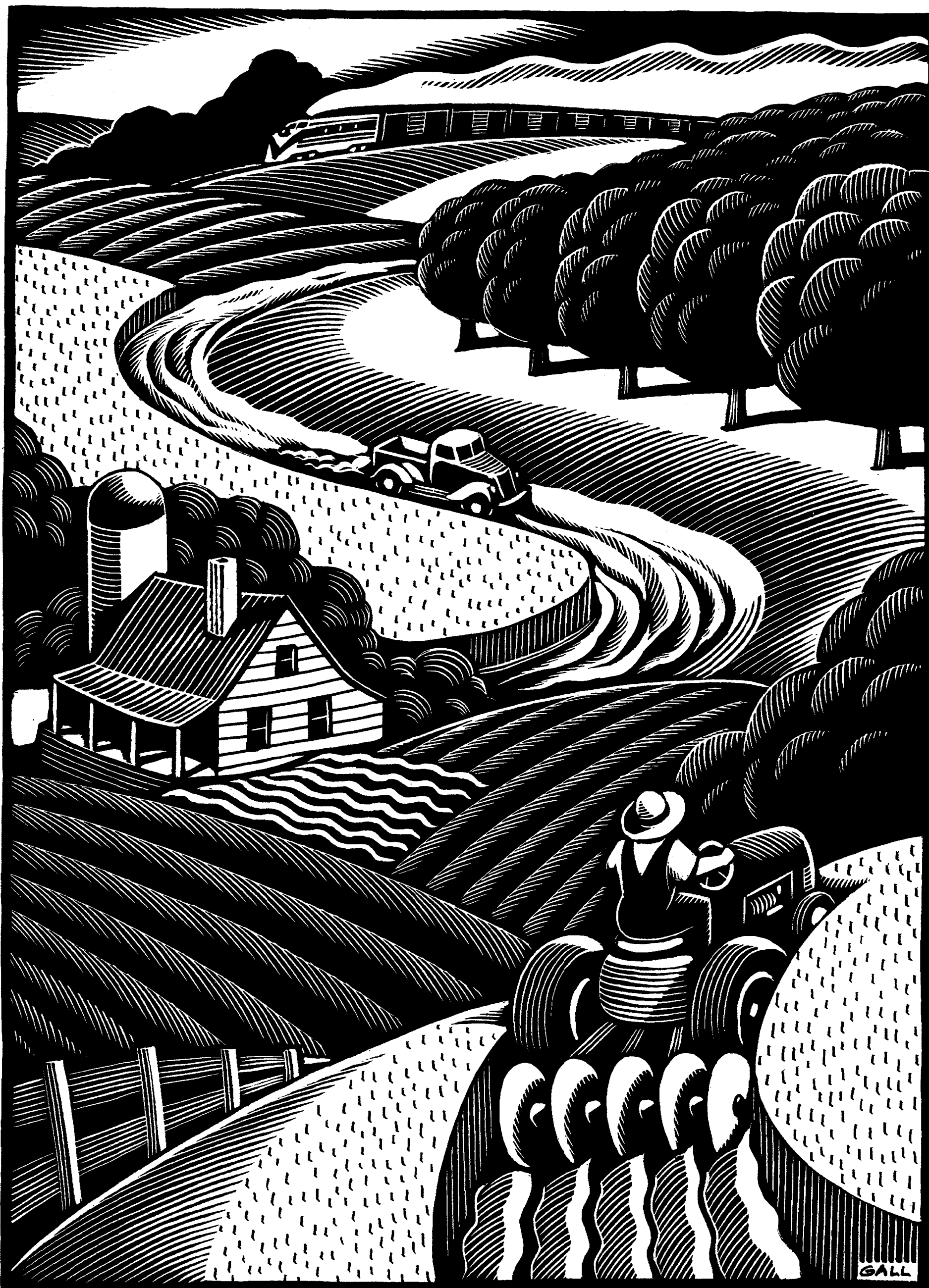

David Schiff's visit to Iowa, August 1996

near Clear Lake 60 miles away, a small plane crashed, killing Buddy Holly, the Big Bopper, and Richie Valens. That was "the day the music died," sang McLean.

I headed south along country roads, gravel and dirt crunching beneath the wheels. The fields, planted with hybrid seed corn, bore the mark of seed producers, generally Pioneer or DeKalb. Selling hybrid seed corn is a better business than farming hybrid seed corn. Unless there's a drought, flood, hailstorm, windstorm, or dust storm, there's usually plenty of corn, which keeps prices low and farmers struggling. Natural catastrophes raise prices, but only because farmers have been hurt and don't have enough to sell.

Producing commodities is a hard life and a tough business. Insurance isn't a tough life, but it's a hard business. More than ever, insurance is a commodity. There will always be good years, but many have forgotten that there will also be bad years—really bad years. The fertile Iowa countryside was, in a way, similar to the fertile conditions in the insurance industry. A boom was building as—with rising stock and bond markets—the fear of a few years earlier had vanished. By the summer of 1996, the recession that had ended in 1991 was becoming an increasingly distant memory, and insurance executives, enjoying the fruit of prosperity, were starting to feel a sense of empowerment that would escalate into conviction that their investments would never decline, that their acquisitions would all be above average, and that they could make money writing business that they had never made money on before.

Not far from Marshalltown—near where David Drury, Principal Mutual's chairman and CEO, grew up—I passed the old Lincoln Highway, later renamed Route 30. Begun more than 80 years ago, it was the first cross-country "highway." (Actually, it was just a series of dirt roads, at first.) Thirty miles farther south was the dreaded Interstate 80, which stretches from New York to San Francisco. In *Open Road: A Celebration of the American Highway*, Phil Patton writes: "The Interstates were created not so much to bind the nation together as to keep things flowing." I stayed off I-80, but many pass through Iowa on its wide expanse of expressway, stopping only to grab a meal at McDonald's. For a traveler moving at 75 miles an hour, the rows of corn become an endless blur, the rolling hills and small communities don't exist, and Iowa—from the Mississippi to the Missouri—can be crossed in a little over four hours.

I arrived in Des Moines on a hot afternoon and went for a walk. Des Moines, with a population of 193,200, is as clean as an operating room and as exciting as an airport lounge. It is an orderly city where people blend in as they go about their business. It is no great melting pot and there are no soapbox messiahs on the street corners.

The city is filled with insurance-company office buildings, with the skyline dominated by 801 Grand Avenue, Principal Mutual's 44-story postmodern skyscraper. The downtown business district is connected by a 2½-mile network of enclosed second-story skywalks that has rendered the streets almost as empty as those of the small towns I had passed through.

That's not to say that Des Moines is devoid of charm. According to the Department of Economic Development, Iowa is ranked as the fourth "most livable" state, and auto insurance rates are among the lowest in the nation. Des Moines doesn't have traffic jams, street hustlers, or piles of garbage. (It doesn't have much in the

way of nightlife or restaurants, either.) Iowa is known for its excellent educational system, and when I asked people if they liked living in Des Moines, they usually responded, "It's a good place to raise a family."

Just before evening I went for a jog. As I headed east, crossing the Des Moines River on an abandoned railroad bridge, the setting sun painted the low, faded buildings in a soft light. Downtown's offices and skywalks receded, and east Des Moines, bathed in warm, golden light, was transformed into an Edward Hopper landscape of old brick buildings and desolate streets. When I eventually turned around and headed back to downtown Des Moines and the setting sun, I was running towards my future—although I didn't know it as yet.

Before I'd left New York, I had spoken by telephone with insurance agents and insurance-company employees throughout Iowa. (I met with several of them as I traveled the backroads). I also made appointments with some of the bigger property-casualty companies in Des Moines. It was the end of August, however, and many people were off on vacation.

I tried to get an appointment at a company with which I was vaguely familiar, whose senior people I had seen briefly in New York some years earlier. It was among the largest property-casualty companies in Iowa, and, therefore, a logical one to visit.

As it turned out, no one at Allied Group was around to see me.

To be continued.

Our next issue will explore the dramatic events at the Principal Mutual public hearing, particularly the dubious testimony given by Principal's chairman and CEO, David Drury, and by Principal's investment banker, Howard Silverstein, a managing director at Goldman Sachs.

We'll also report on the outcome of the proposed merger of Allied Mutual into Nationwide (and the concurrent $1.6-billion acquisition of Allied Group by Nationwide), which, if approved under the proposed terms, would bring to a shameful conclusion what is perhaps the most offensive series of events at a mutual insurer in modern times. As we went to press, the matter was in the hands of Iowa's insurance commissioner Terri Vaughan and assistant attorney general Anuradha Vaitheswaran. ■

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Auto Insurance Report

The Authority on Insuring Personal and Commercial Vehicles

Vol.5#27/218 **April 27, 1998**

Inside

Feds reverse themselves on shrinking size of SUVs. **Page 8**

No-fault debate rages on pages of *USA Today*. **Page 8**

A rarity: drunk driver convicted of murder in death of 4-year old. **Page 8**

Georgia drunk-driving arrests decline sharply from 1991-1996. **Page 8**

The Grapevine

Newspapers Catch On To Falling Auto Insurance Rates

The San Francisco Examiner, The New York Times, The Miami Herald, The Wall Street Journal and other newspapers around the country are catching on to the story that auto insurance rates are starting to come down. Regulators are getting an opportunity to take credit, consumer groups are turning it into an opportunity to bash insurers, and insurers are carefully trying to figure out how to position themselves in the new environment. The newspaper stories are important because they create an expectation among customers that insurers will be forced to fulfill. Once the newspapers are onto the story, television and radio are sure to follow soon. Insurers that don't join the rate-cut-

Please see GRAPEVINE on Page 8

New Diminished Value Software Stirs Controversy With Insurers, Repair Shops, And Consumers

Are **James Lynas** and **Jack Morrow** just small footnotes in the annals of the auto insurance business? Or will they leave a lasting market that will be most profoundly felt in the pocketbook of the average auto insurance company?

Right now it is too soon to say how it will turn out, but one thing is for sure, Lynas and Morrow, purveyors of "diminished value" software, are certainly stirring things up. The two are at the forefront of an effort by body shop owners to force insurers to stop pushing for lower-cost, and they feel are lower-quality, repair strategies. They are the owners of **Wreck Check** and **Accident Check**, software packages that can be used by auto repair experts to quantify the diminished value of a vehicle following an accident.

Lynas started the ball rolling about two and a half years ago with Wreck Check. Without the benefit of seeing

Please see DIMINISHED on Page 2

New Jersey Update:

NJ Assembly Passes Auto Reform; Seeks End Of Territorial Rate Cap

Editor's note: Last week we offered an analysis of the auto insurance reform ideas being discussed in New Jersey. This week we offer a brief report on recent developments. We will complete our state focus report when there is a final resolution of the proposed legislation.

The **New Jersey** Assembly has passed a slightly amended version of the Senate's proposed auto insurance reforms, which include a 15% rate rollback.

The major twist is the Assembly is calling for the elimination of territorial rate caps which keep urban rates within 35% of the statewide average. Suburban legislators are trying to end the subsidies their constituents pay for ur-

Please see NEW JERSEY on Page 7

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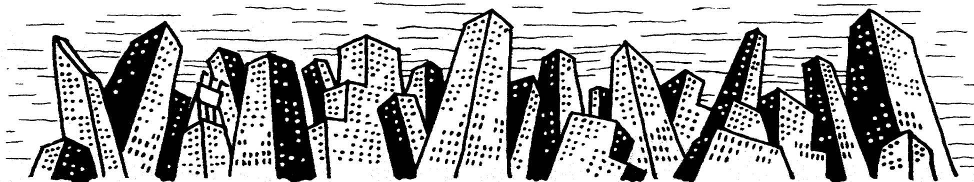


THE INSURANCE BEAT

The Annals of Law

IN ITS JUNE ISSUE of *Insurance and Reinsurance Bulletin*, the law firm Lovell White Durrant took note of a class-action lawsuit filed in New York's Federal District Court. That matter of jurisprudential difference, *Sibley-Schreiber v. Oxford Health Plans (NY) Inc.*, alleges that Oxford improperly denied coverage for Viagra prescriptions. The complaint, which seeks damages in excess of $10 million, was filed on behalf of "one million impotent men."

While we are hesitant to speculate on the ultimate resolution of the case, we have no qualms quoting one expert on the subject of male potency, Mae West, who famously remarked, "A hard man is good to find."

State Senator from MassMutual

JOHN HANCOCK Mutual Life Insurance Company was incorporated in 1862, a mere 96 years after John Hancock, a leader of the American revolution, placed his fancy signature on the Declaration of Independence.

In May 1998, John Hancock (the insurance company) threw in the towel and decided not to screw its policyholders in an abusive mutual-insurance-holding-company conversion. Instead, it announced plans for a full demutualization in which policyholders would receive all the value in the company.

Hancock did not make its decision out of any revolutionary fervor, nor did chairman and CEO Stephen Brown declare it a self-evident truth that mutual policyholders have certain inalienable rights—namely, that they are the owners of a mutual. Indeed, Hancock had been an ardent *supporter* of the proposed mutual holding company legislation.

Hancock's change of heart was a pragmatic decision. Massachusetts did not, at that time, permit mutual holding companies, and the company knew that, were it to go the MHC route in the future, it would have an ugly battle on its hands.

Hancock's capitulation was applauded by many (including us), for it meant that approximately $10 billion of value would be distributed to the company's policyholders.

Not everyone, however, had kind words for Hancock's decision to allow its policyholders to pursue life, liberty and happiness without being shafted by their mutual insurer. Linda J. Melconian, a state senator from Agawam, Massachusetts (near Springfield, where MassMutual, a die-hard supporter of mutual holding companies, is headquartered) had harsh words for Hancock.

"John Hancock's decision is a precipitous action which could threaten two years of good-faith negotiations on mutual holding company legislation," declared Melconian. "It is a slap in the face to MassMutual, Berkshire Life, and other smaller mutuals, all of whom need the holding company option to compete in the marketplace on a level playing field."

Melconian went so far as to say that Hancock's action showed "an impertinence for [sic] the legislative process."

Melconian's statement is an example of tawdry and shameful politics. Did she really believe that Hancock should make decisions *in collusion* with its competitors MassMutual and Berkshire Life? Didn't she think such behavior might constitute a violation of antitrust laws? And why, pray tell, was it *impertinent* to opt for demutualization, the only legal process available at that moment?

When we attempted to question Melconian, she chose not to respond.

There are those who might say that the state senator's failure to respond is a precipitous action and a slap in the face to the public that shows an impertinence for the journalistic process.

Skewed Index

THE STANDARD & POOR'S stock index of multiline insurance companies includes the following: AIG, Cigna, Travelers, Hartford, Lincoln National, and...Loews.

Loews! What is Loews, a conglomerate run by the brilliant Laurance Tisch, doing in the Standard & Poor's Multiline Insurance Index? (For the record, we are a longtime admirer of Tisch and a shareholder of Loews.) Although Loews *does* own 84% of CNA, it also owns Lorillard Tobacco (maker of Newport and Kent cigarettes), Bulova, Diamond Offshore Drilling, Loews Hotels, oil tankers, and an assortment of investments including derivatives that will increase in value if the stock market declines. (Tisch, who has been bearish for a while, is often early but rarely wrong.)

CNA obviously belongs in Standard & Poor's Multiline Insurance Index, but Loews does not.

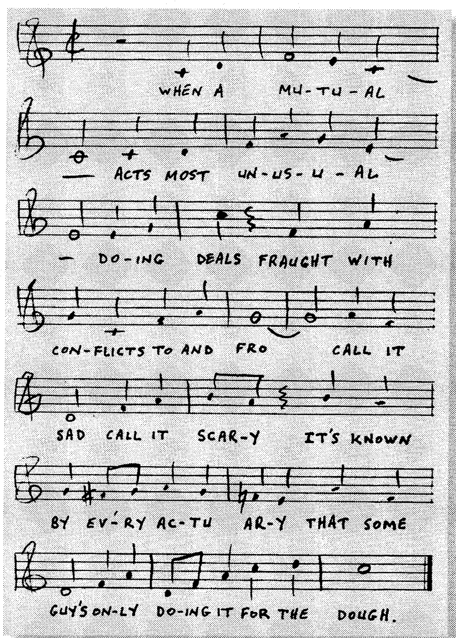
The odds are three-to-one that Standard & Poor's will correct the index within a year.

Mutual Insurance—The Musical

WHILE NO ONE has ever written a musical about mutual insurance, in the mid-1940's one composer did experiment with the idea. Papers recently discovered at the Lincoln Center archives reveal that Frank Loesser developed a show about roguish mutual-insurance-company executives who try to clean out a mutual through a process similar to what is now called a "mutual holding company."

Although Loesser abandoned the project, one fragment discovered in the archives is reprinted below. It bears a striking similarity to the music and lyrics from his classic musical, *Guys and Dolls.*

It was not until 1961, with *How to Succeed in Business Without Really Trying*, that Loesser tackled the subject of business. That time around he won a Pulitzer Prize.



David Schiff, the editor and writer of "Schiff's Insurance Observer," ponders the insurance business.

Instead of doing something productive, like selling waxed fruit, David Schiff, the curmudgeonly editor and writer of *Schiff's Insurance Observer*, has chosen to wile away his time chronicling the madness of the insurance crowd.

Why insurance, you ask? To that same question Haverhill replied (in what was to become known as "Haverhill's reply"), "Why not insurance?"

Insurance, you see, is just like any other business—only worse. It combines the tedious drudgery of banking with the mindless travail of the assembly line. If it were possible to get repetitive-stress syndrome of the cerebrum, one would, undoubtedly, get it from the insurance profession.

It is against this dismal background that Schiff, a sleep-deprived muckraker who covers a sleep-inducing industry, has chosen to ply his trade, seeking the great fame, wealth, and power that comes from writing about insurance.

Of course, *Schiff's Insurance Observer* isn't for everyone. Those who don't have the time for cutting-edge analyses, the stomach for groundbreaking exposés, the guts for hard-hitting commentary, or the sense of humor for seething irreverence are better off not subscribing.

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